DOW THEORY LETTERS INC.

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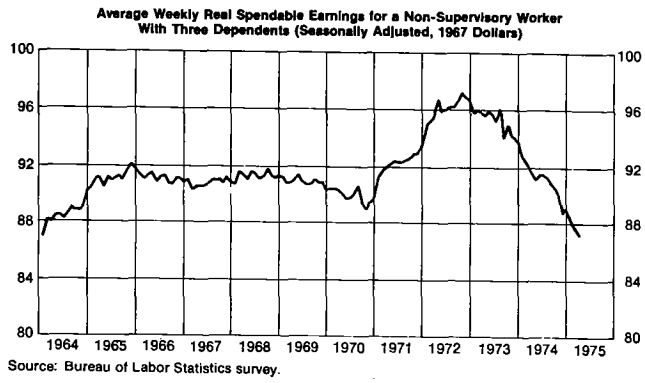
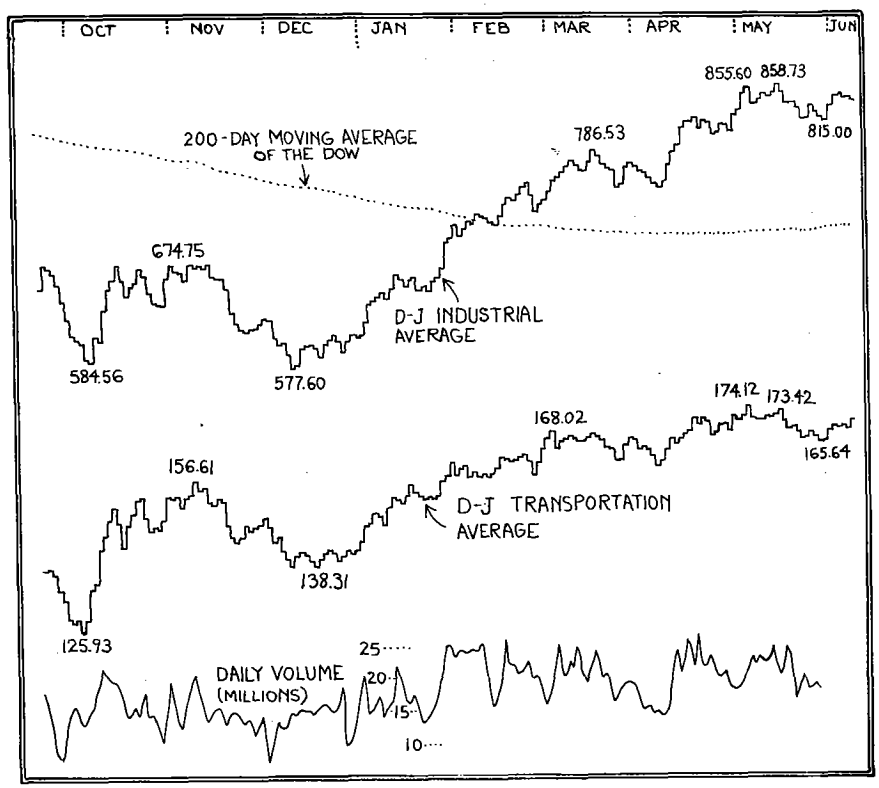
THOUGHTS: You're a genius. You're an analyst for a hot young Wall Street house, and daily you peruse page after page of fresh new financial reports. You take a stack of reports home each night, and you delve even further as you sip absent-mindedly on your third martini. You're eye hits this chart from Henry Kaufman's latest Salomon Bros. "Comments on Credit." You see average weekly spendable earnings for ordinary workers plunging, sinking to the lowest level since 1964. "Holy Cow," you gasp, "they'll never get this economy rolling again the way it was going in the 1960's. Why it's all right here on the chart. The average schnook is watching his earning power go down the drain!" Stocks are too high, you conclude. The big party has got to be over.

On the other side of the country a businessman studies his Wall Street Journal. He reads about the $150 billion US deficit slated for fiscal 1976 and for 1977. He reads that one-third of San Francisco's population is on Welfare or Social Security. He studies the figures on the New York City financial situation. "There's only one place to be," he concludes, "and that place, buddy, is the yellow stuff — gold. Man, before those screwball politicians are through, we're going to be using greenbacks for fuel. Why damn it," he shouts, warming up to the subject, "we're not going to be buying oil with dollars, we're going to be burnin' dollar bills instead of burnin' oil! I say trade 'em in for gold now, while you can still get gold under $200 an ounce."


Average Weekly Real Spendable Earnings for a Non-Supervisory Worker
With Three Dependents (Seasonally Adjusted, 1967 Dollars)
100
96
92
88
84
80
1964 1965 1966 1967 1968 1969 1970 1971 1972 1973 1974 1975
Source: Bureau of Labor Statistics survey.

Both men may be correct in their thinking. But their thinking is very limited. The market sees everything they see — plus much, much more. The first man shorts the market and loses his shirt. The second man loads up on gold bullion and gold shares and sits as his holdings move sideways, fluctuate aimlessly, go nowhere. What happens next? Business picks up but rather listlessly. Inflation continues, but the rate of inflation declines. Investors and speculators pick over the market, hedging against the time when business will turn up in a more convincing way. Corporate earnings rise in many instances, and a period of stability creeps into the economy as the opposing forces of inflation and deflation bring on a kind of economic stand-off.



On the gold front the price of bullion rises to $175, then drops back into a 160-170 trading range. The gold stocks, squeezed by increasing wages, fall back to their late-1974 levels. Many S. African mines cut their dividends, but hopes for the "big gold blow-off" prevent investors from throwing the towel in on the gold shares. Meanwhile, a maverick analyst puts out a report showing that the new Ohio Power preferred's yielding 14% will double your money in five years. To match that performance, bullion would have to hit $340 by 1980. He doesn't believe it will happen.

I include the above fictitious examples of "good thinking" but disappointing results to illustrate my point. While you, as an investor, may see a developing situation clearly, you cannot (1) foresee the countless other factors that may throw your original premises off, and (2) you do not know how the market will react to your concepts.

The fact is that investors have seldom been faced with a more complex situation than the one that they are confronted with today. For instance, despite declining short-term interest rates (declining because bank loans are falling), long-term interest rates remain high. Last week saw New York State (not the City) pay 6% for tax-free 10-month notes. The same week saw that State pay an amazing 9.75% for its long-term Dormitory bonds (also free from Federal taxes). The fact is that the State's bonds are rated AA, and this is a huge rate for the State to pay. So after decades of bad news for lenders (and I'm talking about the ravages of inflation), the guys who put up the money are finally getting paid for it — in spades, via very high rates of interest.

"But," you ask, "what happens if business starts expanding? If medium to long-term interest rates are historically high now, what will they pay if business booms?" And that's a very tricky question. Because part of today's fat interest rates are due to fear, fear that many borrowers aren't going to make it. And if business does stabilize, if the Utilities turn the corner on their problems, if some of the battered invalids like NYC and Consolidated Edison and W.T. Grant start doing what they have to in order to stay alive, then the fear will decrease and interest rates could level off or even come down .

And if business does not really pick up, if a certain amount of deflation comes into the picture, this too could bring interest rates down and thus be a long-term plus for the economy. It could also be a depressant for gold. And there is no assurance at this time that business can't stall out over the next year. But the point I am trying to make is that it is best to question the obvious. The roar of coming inflation is "obvious." The tempo of rising business is "obvious." The fact that the market will be higher six months from now is "obvious."

Yet history shows us that there is nothing on Wall Street that is obvious or a sure thing. And that is really what my job is all about — trying to cut through the bunk, the sure things, the obvious plays, and in so doing help my readers. I want to repeat again something I have not mentioned for a number of years. The seasoned investor thinks of investments in terms of three factors, and in the following order: (1) safety, (2) return, (3) appreciation. Conversely, the amateur (the public) thinks about the same three factors but in this order (1) appreciation ("Will it double in six months?"), and (2) return, and (3) safety. And that's why the rich tend to get richer while the public tends to lose its shirt.

I just finished the latest (June) issue of the authoritative Bank Credit Analyst (1245 Sherbrooke St. West, Montreal 109, Ont. Canada). Editor Tony Boeckh sees a variety of problems militating against a big business recovery now, and he lists them as (1) a continuing drop in capital spending with continuing high long-term interest rates, (2) continued need to liquidate mammoth inventories following "the largest speculative inventory and commodity boom since the 1920's." (3) A liquidity preference in banking circles, in the corporate sphere and in the public sector. Net worth of individuals, says Boeckh, is now 40% below 1968 levels while individuals' real disposable income is at 1964 levels. (4) The Fed is increasing the reserve base at the banks at a rate which is still only accomodative, not expansionary.

In the face of all this, concludes Boeckh, business is likely to "remain very disappointing." Based on projections currently put forth by the Bank Credit Analyst, Boeckh thinks that price deflation could extend longer than people think, and that it could be more severe than most people think (perhaps the downward adjustment could extend well into 1976). Following this, Boeckh believes that the economy will turn up accompanied by an explosive rise in the inflation rate (as the current build-up in liquidity hits the market with full force).

As stated here before, each new spate of inflation since World War II has been greater than the last. And each new round of re-inflation has required a correspondingly greater infusion of bank credit. Boeckh computes that it will take $700 billion in bank credit over the next 3½ years (a 100% increase) to bring about "good business" as against $272 billion during 1970 to 1974 and only $74 billion during 1966 to 1968!

All of what Boeckh says fits in with my own feeling (expressed here over the past months) to the effect that business is going to be much harder to "start up" than most people envision. The big question in my mind is this: If business is unexpectedly sluggish in second half 1975 or even through early 1976, will the stock market take that in its stride (i.e., has such a possible continuing slump been discounted) or will we get a major secondary correction as Wall Street seeks to protect itself against the dangers of further recession and profit erosion?

The only hints to that question will be provided by the market itself. And of course that entails all our technical studies, all our skills and all our intuition. And that's the reason I deal with three basic problems in these reports, the three problems being (1) What is the market trying to tell us, (2) How does that fit into economic conditions as we see them or as they appear to be developing, and (3) How do we operate in view of the total picture.

In this paragraph I'll present a scenario (call it plan #1) based on what I consider a very real series of possibilities. First, business continues to drag, and after an initial "tax rebate pop," the economy begins to drag again, extending its sluggishness through the remainder of 1975 and well into 1976. At first, the Fed ignores what is happening, but as unemployment remains high, the clamor for "more credit" and "lower interest rates" grows louder. Great pressure is brought to bear on the Fed, and finally the Board moves to a more expansionary policy. Interest rates decline sharply, bonds rally smartly, and the nation's liquidity builds in all sectors. Gold and gold shares, under the pressure of price deflation back and fill, most

sink lower. The stock market, confronted with the unexpectedly bad news, undergoes a major correction. Near the end of the reaction, subscribers sell all fixed income securities and move heavily into common stocks again (while greatly enlarging their gold positions). The bull market takes off again, accompanied by massive inflation.

Now let's kick around what I call plan #2. According to this plan, business bottoms out around June or July or even during late 1975. Then under the spur of tax rebated and a public realization of "the turn," the economy gathers upside momentum. Seeing all this, the Fed continues its conservative accomodative stance ("After all, we don't want this whole thing to turn into galloping inflation by election time, 1976!"). Interest rates rise rapidly as business borrowing (as well as public spending) expands. The economy is further spurred by heavy defense spending.

In the face of the new prosperity, bonds drop back and conditions become almost frightening in the money markets. Aaa-rate bonds push through the 9% yield level, and T-bill yields move above 8%. Gold stocks do little as they confront the twin problems of the new inflation and booming interest rates. The stock market turns schizophrenic as many well-financed companies increase their earnings sharply while other less able outfits run into money problems and fair poorly. The market becomes speculative and highly erratic. The spike which traces the path of the velocity of bank deposit turnover and the spike which traces the path of the Dow Industrials extend like twin church steeples stabbing into the sky. Prodded by inflation fear and the lust for profits, the public throws caution to the winds and rushes into Wall Street with both feet. Exchange volume rises to record highs. Then, as a few conservatives have been warning, the unexpected....

TECHNICAL RUNDOWN: Let's cut out all the inferences and guesses and take a hard look at the technical position of the market today.

(1) On June 3 the D-J Utility Average hurdled its February, 1975 peak of 81.96. This is a long-term plus for the market (but not necessarily a short or intermediate-term plus). The bellwether Treasury 4½ bond of 1987-92 rallied to new 1975 highs last week. This is also a plus (long-term) for the market.

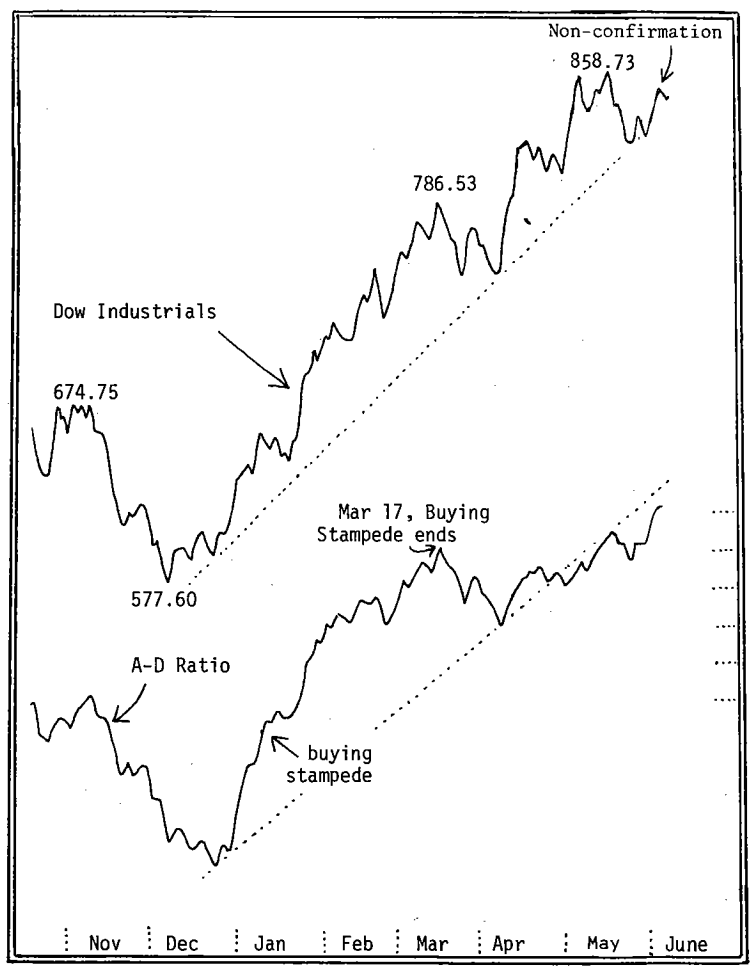
(2) At the May 14 peak of 858.73 (i.e., the 1975 high), the Dow had risen 25% above its own 200-day moving average. In the past, a move by the Dow of 25% or more above its MA has indicated a strained technical situation. I believe we are there now. From yet another point the pressure is evident. The advance in the Dow from December's 577.66 to May's 858.73 represented an advance of 48.7% within a period of five months. That's hardly a record (during 1932 the Dow doubled in a period of two months). However, a rise which average 56 Dow points per month for five consecutive months is enough to bring on a condition of technical strain.

(3) At the latest reading, the 13-week moving average of the Dow stood at 803 while the 50-week MA was 714. This means that the 13-week is continuing in the bullish position above the 50-week MA (see Letter 628). But the current 89 point spread between the two MA's is considerable, and it could call for a slowdown or a correction.

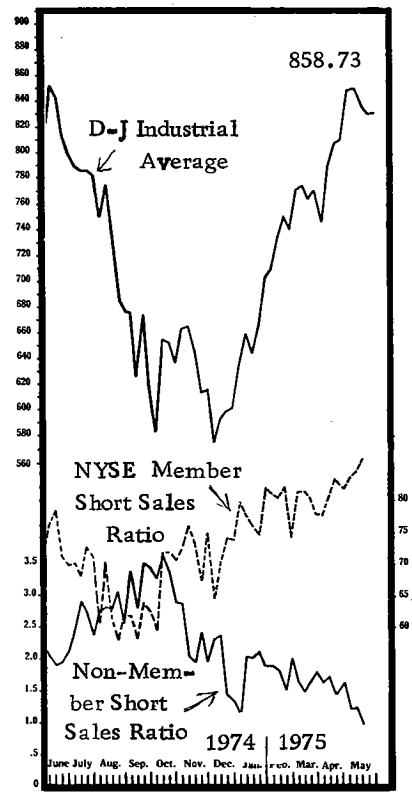
(4) Odd-lotters have remained well on the sell side of this market with the 10-day ratio of purchases to sales at around 200 (200 shares sold for every 100 purchased). Last week, however, there was a definite move by odd-lotters towards less selling, and this is negative for the market. Odd-lot short sellers are an entirely different breed from the odd-lot buyers. The odd-lot shorts are real speculators, but they tend to be wrong at the extremes of the price movement. Odd-lot shorts have been singularly inactive during May, and this is another reason for caution on our part.

(5) The most-active stocks indices continue to be the strongest single technical segment of the market. As of the latest reading, both of the most-active stocks indices are in a positive position with the cumulative index (see Letter 632) at a new 1975 high as late as June 5.

(6) My Elliott Wave studies imply that we are in a new bull market cycle, and probably the last major up-wave of the huge super-cycle which began in 1932.



This bull market should ultimately be the most inflationary of any of the bull markets since 1932.



(7) Will-Go, the index that is based on the comparison of the yields on the Dow and the yields of Barron's Hi-Grade Bonds, is unequivocally bearish here as it has been for many weeks (Will-Go has dropped for eleven weeks in a row). Will-Go is saying that the market should go lower and is predicting a reaction starting at the end of May (which is past) right through to early August (see Letter 629).

(8) NYSE member short sales as a percentage of total short sales have now risen to 86%. Meanwhile, public round lot (over 100 share) short sales have dropped under 1% of total short sales. Both of these indices are at bearish extremes now (bearish for the market), with member short sales taking up a large percentage of total short sales and public short sales taking a small percentage. Since the public tends to be wrong and the members tend to be correct, the short situation is now presenting a negative picture (see chart courtesy of M/G Financial Weekly).

(9) I am saving the most important technical considerations for last. On January 27 the Industrial and Transport Averages signalled a primary bull market for Wall Street (see Letter 621). Under Dow Theory, a trend is taken to remain in force until proved otherwise. Nothing has occurred since January 27 to make me think that the primary trend of the market is anything but bullish.

The price structure is worth examining carefully at this time, however. Note on the page 1 chart that the two Averages recorded 1975 highs on May 5 (Industrials at 855.60, Transports at 174.12). A minor decline ensued, following which the two Averages rallied again. On May 14 Industrials hit a new 1975 peak of 858.73, but Transports refused to confirm. A new decline took Transports to 165.64 on May 28, Industrials to 815.00 on May 29.

An early June rally then carried the two Dow components to minor peaks (well below their May highs). But here the Industrials Average showed a remarkable and almost eerie resistance to advance. Thus, the non-confirmation episode of May 5 to May 14 still stands as a distinct caution signal for the market. Because of the May non-confirmation, I feel that any decline which might now take the two Averages below the May lows should be accepted as a definite warning signal of trouble to come (May lows are 815.00 for Industrials, 165.64 for Transports). Obviously, a new Dow high above 858.73 would be a very constructive event at this time.

(10) As seen on the page 3 chart, the advance-decline ratio (last week) rallied to a new 1975 recovery high, a high which was about one point above the March 17 peak. This action has generated a good deal of bullishness among my fellow analysts. But I want to warn subscribers that the Industrials have not yet confirmed the new highs in the A-D ratio. A confirmation would obviously entail an Industrial closing above 858.73.

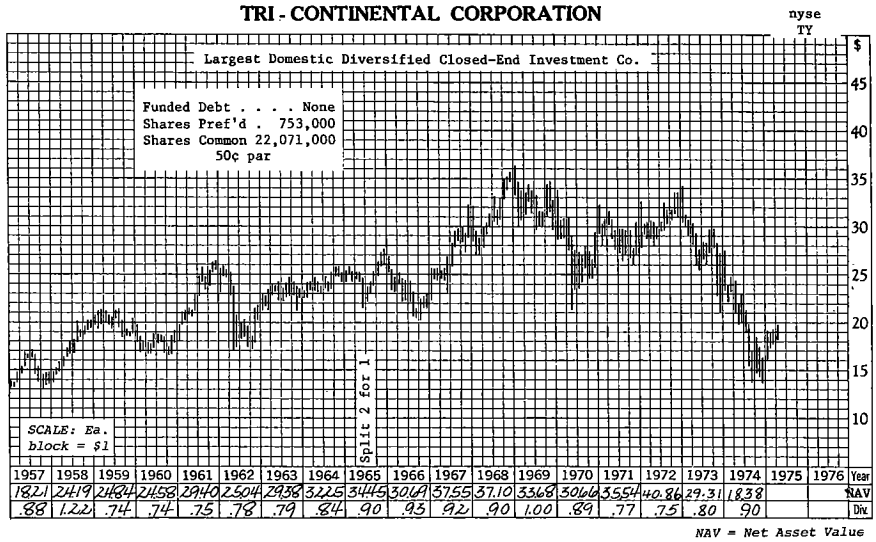
Most of today's technicians are used to trouble being signalled by a high in the Dow unconfirmed by a new high in the A-D ratio. But history shows that the reverse can just as surely signal trouble in the market. Owners of A-D ratio chart albums might study the Dow non-confirmation of April, 1934 or September, 1941 as an aid to understanding what happens when the Dow stubbornly refuses to confirm a new high on the A-D ratio. Remember, the 30-Dow Industrials are probably the most studied and analyzed stocks in the world. When those thirty stocks refuse to follow the rest of the market (as gauged by the A-D ratio), there is usually a good reason for the bearish action.

Conclusion: The bull market which began in October, 1974 developed extraordinary upward thrust and momentum. I have stated repeatedly that during a bull market the upside deserves every benefit of the doubt — and I mean just that. Nevertheless, it might be well to note at this time that many of the "psychology of the market" studies such as odd lots, odd-lot shorts, advisory sentiment, etc., are now showing signs of deterioration. As far as "character of the market" studies are concerned, the preceding paragraphs have detailed the problems which have appeared in the price structure. In these reports I talk about what I see, I express a few of my hopes, and I frequently write about my worries. But my typewriter won't set off any rallies or declines, nor will it solve any of the technical problems of Wall Street. I try to put down on paper whatever is on my mind, but in every case you will have to make up your mind regarding what to do about it. And in many instances, your conclusions and your actions will be superior to mine.

In recent Letters I have been advising caution, which is a marked departure from my extremely bullish stance of December, 1974. Lately, I have suggested a general move to the sidelines for subscribers with only selective positions in such stocks as Lockheed, United Technologies, General Dynamics and Homestake Mines (see last report). And for those who wish to ride the trend to lower interest rates, I have recommended (Letters 630 and 631) the US 7-3/4 notes of 1981. These notes are now 3 points ($30 on each $1000) above where I first recommended them. I think they're going still higher. I might add that when I first said "Buy the notes" everyone was saying that interest rates were going up, based on predictions of a sharp upturn in business (which demonstrates again that "everyone" can be wrong).

NOTE: After writing the preceding, I received Barron's (June 9), and I want to add a comment on Barron's Confidence Index. This Index (see Letter 630, page 4) is the ratio of the yield on Barron's Hi-Grade Bonds to the yield on the broad D-J 40-Bonds. Last week the CI dropped to 89.3, the first time it has been under 90 in over four years. Meaning: Bond buyers (and they tend to be sophisticated investors) are moving towards the highest grade bonds rather than medium quality. This drop in confidence could also show up in the stock market (market lore has it that important movements in the CI precede comparable movements in the market).

STOCKS: One of the great mysteries of the market is the discount from net assets to which the closed-end funds are subject. A closed-end fund is a fund which is traded exactly as any other common stock, regardless of assets (in contrast to mutual funds which trade at asset value). When you buy a mutual fund your money goes to the fund and the fund issues the stock to you. When you buy a closed-end fund, you buy it on the exchange from a seller and the transaction in no way affects the closed-end fund's assets.



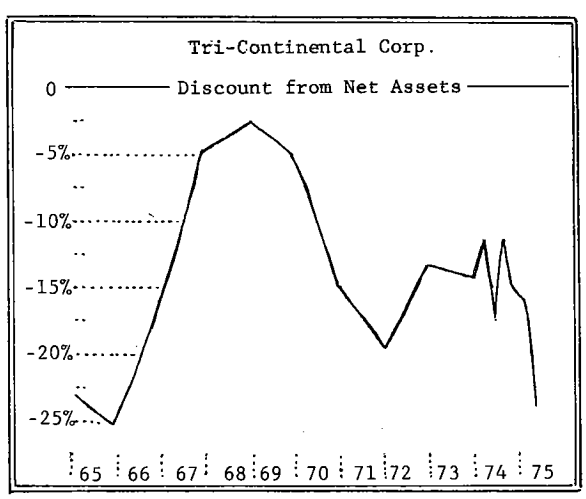
There are many listed closed-end funds, some diversified, some specialized. The largest of the closed-end funds is Tri-Continental, which is traded (TY) on the NYSE. At the latest tabulation, TY had $24.40 in net assets and was selling for 19, or around 22.19 below net assets. TY is an old fund, under excellent and seasoned management, and boasts assets of around half a billion dollars, with around 85% of those assets in common stocks.

The interesting thing about a closed fund such as TY at this time is that here in a bull market you can receive (for the purchase price of 19) the full income and action on $24 worth of quality equities. Income per share for TY should be around 90¢ this year, plus any capital gains distributions the fund might make. These distributions can be considerable, $1.95 in '74, $2.05 in '73, $1.52 in 1972.

Why do I mention TY at this time? The accompanying chart provides the reason. Over the last eleven years the discount below assets for TY varied from roughly 3% to as much as 25%. At the December, 1974 lows TY sold at around 10% under its net assets of $15. Now, with net assets up at $24, the TY common is selling at around 21% below assets. Thus, I believe TY represents good value here, and it is selling near its widest range of discount below net assets.

If and when this bull market becomes frothy, my guess is that TY will move up near actual net assets (as it did in early 1969). That would be a big plus for those who buy TY at a major discount of 20% or more below net assets.

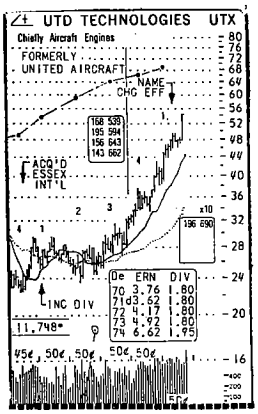
I mention TY at this point because although timing is always important in the market, I feel that TY purchases require less timing skill than most. A subscriber could buy 25% of intended TY total commitments here, another 25% if the stock drops back to the 16-17 level on a reaction. If market strength continues one could purchase 25% of his commitment here, then another 25% if TY rallies over 20½. To keep the record straight, the high for TY was set in 1969 at 36-3/8. The 19-year low was set last year at 13-5/8. At 19 TY has regained only 23.6% of its 1969-1974 losses. This arithmetic scale chart by Horsey (Salisbury MD 21801) shows you the monthly TY story.

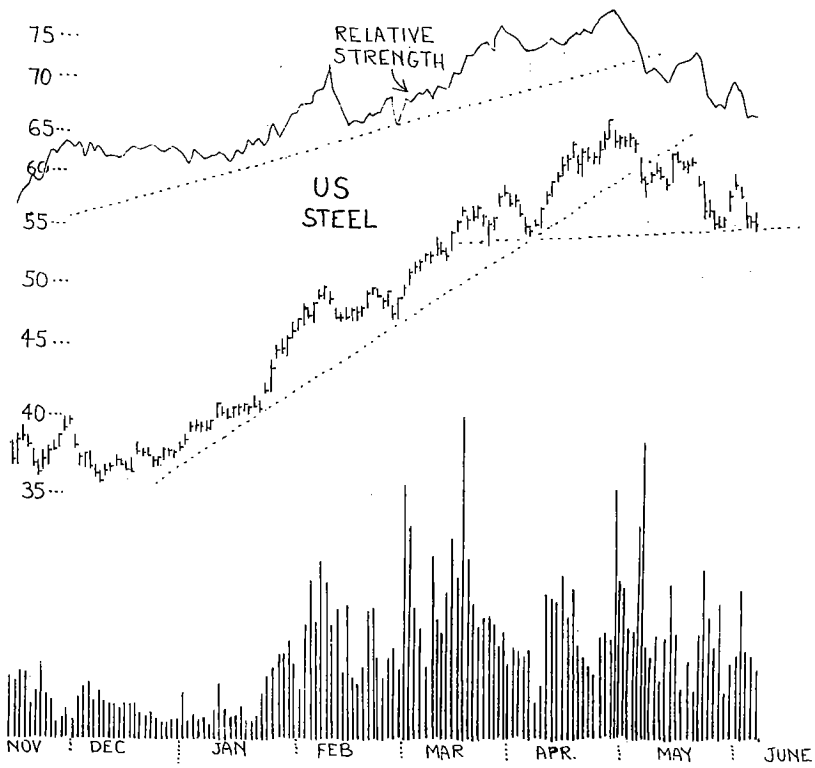


STOCKS: I recommended US Steel in Letter 621, when it was in the 46-48 range. Subsequently, as you can see on the page 6 chart, Steel enjoyed a sensational run up to 66, amid Wall Street reports of $10 to $11 earnings next year. I assume that subscribers have now sold Steel (within the contect of my "to the sidelines" advice). At any rate, I want to point out that Steel was one of the big sparks under the 1975 market advance. That spark has now died out.

In April Steel reversed its relative strength trend to the downside. A large "head-and-shoulders" top has formed in Steel with the crucial support line at around 55. Not all H & S tops "work out" in bull markets, but a H & S top is almost an indication of important distribution. If you still hold Steel, I would not hold it if it breaks below 55. Personally, I don't know "what's wrong" with the stock, but then I'm not

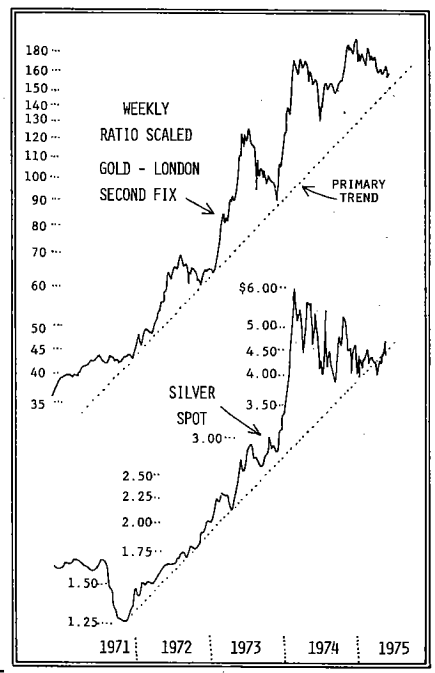
sure it's necessary for me to know. Suffice it to say that the market is saying "There's something wrong in the steel picture."





In the meantime, United Technologies, which I have been recommending since the low 30's, exploded today on the news of the monster F-16 plane sale. The whole world is now in the midst of an unbelievable arms-buying binge. Now that the Arabs have all that wealth, they want to protect it, and this means they're going to spend their heads off for the latest in weapons. Nothing is more inflationary than huge arms purchases, because arms cost astronomical sums, and those sums are totally wasted in that they produce nothing of value, nothing which goes to generating wealth or savings. Thus, an arms build-up destroys money and wealth. That destruction is ultimately financed by deficits, which in turn erode the value of paper money. So as for the giant F-16 contract, cheer for the aerospace industry, cheer for General Dynamics and United Technologies, weep for paper currencies, weep for mankind.

GOLD: Secretary Simon has announced that the US is dumping more gold on the world auction market, but Mr. Simon (being a Wall Streeter) should know that the market never discounts the same thing twice. Thus, gold broke below $162 for a day, bounced back, then settled into the trend it was in before the news. My long-term chart of gold and silver shows silver having broken its major trend since 1971 and gold moving generally sideways since late-1973 (and actually it is now well under its early 1974 peak). If gold remains in its current 165 range, it will move sideways through and below its primary trend line within 13 weeks.



Despite this less-than-exciting picture for the metal, I will repeat that I see no reason why subscribers shouldn't put 15% of assets in a mix of Krugerrands and Homestake common shares. I say this because the fundamentals are slowly, very slowly being put together for explosive monetary inflation perhaps in 1976 or 1977. As this little clip below indicates, current trends suggest that in a matter of time the entire population of the US will be on welfare or Social Security roles with perhaps only the politicians actually working. Now I admit that's an exaggeration, because we'll be broke long before it happens. But the "free lunch" trend means deficits and destruction of paper money. Gold always stands still in value, it's the paper that goes down in value. Ultimately, unless we go into a depression, the "holding period" since 1973 will give way to a big move in gold. That move is not here yet, but I want my subscribers to get their feet wet, and that's why the 15% holdings in gold.

THANKS: I want to thank the great number of subscribers who extended their subscriptions from one to three years. I couldn't possibly answer all the attached letters, but I read each one carefully, and again my thanks. Many of the comments were most interesting, some were highly personal, and scores mentioned money made in the market (as well as losses that were avoided). Subscribers evidently like the occasional philosophical essays, and I don't know why but that always surprises me. One subscriber wanted to know if there is a pro-rata refund in case of a subscriber's death, and the answer is yet, but I'd rather you'd stay healthy (and I'm not advising that for selfish reasons). Another subscriber (from Missouri, naturally) wanted to know about my health in view of his three-year renewal. My health is good, I sold my two motorcycles in January and I fully intend to last out the next three years and probably a good while longer. Again, thanks for all those extensions.

FINALE: UTX chart courtesy Quote, PO Box 213, Wichita KS 67201. Bob Gross, I'm sorry I couldn't make the San Francisco seminar; I spent the weekend working on what you're reading. Next mailing: June 20th.

N.Y. Welfare Recipients Top 1 Million

NEW YORK (AP) — Welfare rolls passed the one-million mark here in May, putting one out of every eight men, women and children in New York on welfare, Commissioner James Dumpson said yesterday.

He said the number on public assistance would climb to an all-time high in July. The previous mark of 1.2 million was set in 1972, but it included disabled, aged and blind people who have since been transferred to a federal income supplement program.